IN THE

Supreme Court of the United States

OCTOBER TERM 1941

No. 757

In the Matter of The Prudence Company, Inc., Debtor.	In Consolidated Proceedings for Reorganization under Section 77B of the Bankruptcy Act
In the Matter of Amalgamated Properties, Inc., Debtor.	Nos. 27496 and 27028
In the Matter of A Plan of Reorganization of Amalgamated Properties, Inc., Debtor, in respect of the Zo-Gale First Mortgage Participation Certificates.	
Prudence Realization Corporation, Petitioner. A. Joseph Geist, Trustee, Respondent.	

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

A. Joseph Geist,
Attorney for Respondent.

Morris A. Marks,
George E. Netter,

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Statement of the Case

The Prudence Company, Inc., a banking corporation organized under the laws of the State of New York, loaned

Zo-Gale Realty Co., Inc., a sum of money secured by a bond and a first mortgage covering premises 202 Riverside Drive in the City of New York (R. 16).

The Prudence Company, Inc., assigned the bond and mortgage without consideration to a corporation known as Prudence-Bonds Corporation. The stock of both corporations was owned by a parent corporation, New York Investors, Inc. (R. 39).

Prudence-Bonds Corporation, under a plan described at length in *In re The Westover, Inc.*, (2 Cir.) 82 F. (2d) 177, and *In re Prudence Co., Inc.*, (2 Cir.) 89 F. (2d) 689; *In re Prudence Co., Inc.*, (2 Cir.) 98 F. (2d) 559, cert. den. 306 U. S. 636, 59 S. Ct. 485, 83 L. Ed. 1037; *In re Prudence Bonds Corp.*, (2 Cir.) 79 F. (2d) 212 (R. 20), deposited the bond and mortgage with a depositary, and thereafter, at the request of The Prudence Company, Inc., it issued participation certificates of undivided shares in specified amounts, delivered them to The Prudence Company, Inc., which affixed its guarantee to the certificates and sold them to the public and retained the proceeds (R. 38-39).

The relationship of guarantor and creditor was thus created between The Prudence Company, Inc., and the certificate holders. A. Joseph Geist, as trustee, holds the trust estate for the benefit of the certificate holders (R. 10-11). The certificates in the instant proceeding are known and referred to as the Zo-Gale Certificate Issue.

The participation certificates did not reserve to the guarantor, The Prudence Company, Inc., the right to hold or retain similar shares for its own account (R. 36-37).

The original obligor defaulted and, to avoid foreclosure proceedings, conveyed the premises securing the mortgage to Amalgamated Properties, Inc., a subsidiary corporation of The Prudence Company, Inc., which owned all its stock. The trustees of The Prudence Company, Inc., debtor, constituted the board of directors and were the officers of Amalgamated Properties, Inc. (R. 5).

The Prudence Company, Inc., defaulted under its guarantee and filed a petition for reorganization under Section 77B of the National Bankruptcy Act on February 1, 1935 (R. 5); on March 17, 1936, the petition of the subsidiary corporation, Amalgamated Properties, Inc., debtor, for reorganization under Section 77B of the National Bankruptcy Act was approved as duly filed in the proceedings of The Prudence Company, Inc., debtor (R. 5).

At the time of the filing of its petition for reorganization under Section 77B of the National Bankruptcy Act, The Prudence Company, Inc., debtor, owned $7,000 par amount of unissued Zo-Gale participation certificates (R. 8, 39) and $816 of repurchased and reacquired Zo-Gale participation certificates (R. 11, 40).

The plan for the reorganization of the Zo-Gale Certificate Issue "In the Matter of Amalgamated Properties, Inc., debtor," was confirmed by order of the United States District Court for the Eastern District of New York on February 19, 1938 (R. 7). This order reserved for future determination the question of the parity of the participation certificates owned by The Prudence Company, Inc., debtor (R. 8-9) in the proceedings of Amalgamated Properties, Inc., debtor, with those guaranteed by it and sold to the public. The order of consummation was entered on April 9, 1939 (R. 9). The fee to premises 202 Riverside Drive and to the bond and mortgage were transferred to A. Joseph Geist, trustee respondent, pursuant to the order of confirmation "In the Matter of Amalgamated Properties, Inc., debtor" (R. 10-11).

The narrow issue which the petitioner presents for consideration is:

Shall the assets of Amalgamated Properties, Inc., debtor, in the Zo-Gale Certificate Issue be distributed ratably between A. Joseph Geist, trustee respondent, and the Prudence Realization Corporation, successor of The Prudence Company, Inc., debtor, the two holders of the mortgage security (evidenced by the participation certificates),

thereby disregarding and ignoring the default committed by the guarantor debtor, The Prudence Company, Inc., debtor, in violation of the equitable rule existing between guarantor debtors and creditors, or shall the construction placed upon the contract (the participation certificates) by the Court of Appeals of the State of New York, the United States District Court for the Eastern District of New York, and the Circuit Court of Appeals for the Second Circuit, which give due consideration to the existing equitable principles, prevail and be applied.

The petitioner bases its application for a writ of certiorari on the palpably erroneous theory that the District Court and the United States Circuit Court of Appeals for the Second Circuit failed to apply the bankruptcy principles of equal distribution in distributing the assets of The Prudence Company, Inc., debtor.

The question before the court does not involve the distribution of the assets of The Prudence Company, Inc., debtor, among its general creditors in the proceeding pending for the reorganization of that corporation under Section 77B of the National Bankruptcy Act. It concerns itself solely with the validity and order of priority or subordination of the interest held by The Prudence Company, Inc., debtor, in the mortgage upon the premises of Amalgamated Properties, Inc., debtor, of which mortgage The Prudence Company, Inc., was also a guarantor. It is not a mere coincidence that The Prudence Company, Inc., debtor, is the holder of some of these participation certificates. That it contemplated holding or acquiring such certificates is clearly evidenced by the language incorporated in the certificates sold to the public (R. 36-37); but it is likewise evident that any certificates owned or thereafter reacquired by it would be subordinate in interest to the certificates sold to the public, for while it reserved to Prudence-Bonds Corporation the right to hold similar certificates for its account, it did not reserve that right to itself (R. 37). It is by virtue of the ownership of such junior participating certificates, aside from the relation-

ship created by virtue of its guaranty, that the creditors of The Prudence Company, Inc., debtor, are interested in the proceeding entitled "In the Matter of Amalgamated Properties, Inc., debtor".

Question Presented

The true question concisely stated is: Did the courts below err in holding that the well-settled law of the State of New York was determinative of the order of priority of the respective interests in the mortgage on the property of Amalgamated Properties, Inc., debtor? Petitioner contends that the courts below should not have followed the well-settled State law to the effect that the interest in the certificates held by The Prudence Company, Inc., debtor, was subordinate to the interest in the outstanding certificates which were sold to the public with the guaranty of The Prudence Company, Inc., debtor; and that the courts below should have held, contrary to the well-settled law, that the respective interests were on a parity.

We respectfully submit, however, that questions as to the validity, priority and subordination of the interests in a mortgage on the property of a debtor are necessarily governed by the law of the State and that the courts below properly and correctly applied the law of New York State as settled by the authoritative decisions of the New York Court of Appeals.

The determination of the court below is in accordance with the decisions of the Court of Appeals of the State of New York, in complete harmony with cardinal principles of administration of insolvent estates and consistent with the intention of the parties succinctly expressed in the participation certificates prepared and sold by The Prudence Company, Inc., with its guarantee.

See:

Harvard Law Review, Vol. LV, No. 2, Dec. 1941, p. 283.

See also:

In re Prudence Co., Inc., (2d Cir.) 82 F. (2d) 755, cert. den. 298 U. S. 685, 56 Sup. Ct. 958, 80 L. Ed. 1405.

A writ of certiorari should be denied because the participation certificates held by the Prudence Realization Corporation, the successor in interest of The Prudence Company, Inc., debtor, constitute a subordinate interest in the mortgage

(a) by the very terms of the participation certificates;

(b) by virtue of the default committed by the debtor guarantor, The Prudence Company, Inc.

POINT I

The existence of the debtor-creditor relationship precludes and estops The Prudence Company, Inc. and its successors in interest from asserting that the certificates held by it are on a parity with those held by the general public.

The Court of Appeals of the State of New York has reviewed the relationships arising out of the sale of guaranteed mortgage certificates to the public and has stated clearly and unequivocally that the ownership interest retained by guarantor companies is subject and subordinate to the certificates sold to the general public and that such guarantor companies are not entitled to share in the distribution of either interest or principal until the certificate holders are paid in full unless the certificates sold and delivered to the public, specifically and unequivocally, provide that the guarantor is entitled to share with the certificate holders in the distribution of the moneys received from the mortgagor. See *Pink* v. *Thomas*, 282 N. Y. 10, where the Court said:

"* * * *but if a mortgage company guarantees payment of certificates which it sells to third parties it is not entitled to share in the proceeds received from the sale of collateral until the third-party certificate holders are paid in full unless the certificates sold clearly provide that it retains such right* (Matter of Title & Mortgage Guaranty Company of Sullivan County, 275 N. Y. 347), *the underlying principle being that a mortgage company which sells participating certificates in a mortgage and itself guarantees them is in the position of a debtor, and the equitable rule existing between debtors and creditor applies.* On default and absence of sufficient funds to pay certificate holders other than itself in full it cannot share in the assets available until the certificate holders are paid in full. That is the law, and it is right. Having guaranteed the payment of the certificates it would be highly inequitable to permit it to step in and divert part of the security available to pay such certificate holders whom it had expressly guaranteed should be paid. No one in this case questions that principle.

It should take very clear and unambiguous language in the certificates to overcome that rule and substitute a holding that in spite of its guarantee of payment it should be permitted to share in the available assets even though the certificates which it had guaranteed should be paid remained unpaid. Such an inequitable result could be accomplished if the language used was so clear and unmistakable that the courts would be compelled to give effect to the intent of the parties as expressed in the writing. Otherwise the equitable rule should prevail." (Italics supplied.)

See also:

In re Union Guarantee & Mortgage Co., 285 N. Y. 337, 34 N. E. (2d) 245.

POINT II

The decisions of the Court of Appeals of the State of New York are determinative of the validity, priority or subordination of the interests owned by The Prudence Company, Inc., debtor, and A. Joseph Geist, trustee respondent, in the mortgage upon the property of Amalgamated Properties, Inc., debtor.

See:

Lerner Stores Corporation v. *Electric Maid Bake Shops,* (5 Cir.) 24 F. (2d) 780, 782.

"* * *, if the property in the hands of the trustee is covered by two liens under the state law, it is necessary to determine which takes precedence, and the order of the liens fixed by the state law will be enforced. Pretorius v. Anderson (C. C. A.) 236 F. 723."

In *Re Knox-Powell-Stockton Co.,* (9 Cir.) 100 F. (2d) 979, at page 982:

"The laws of the state where the adjudication is had are controlling as to the validity and extent of the lien. York Mfg. Co. v. Cassell, 201 U. S. 344, 26 S. Ct. 481, 50 L. Ed. 782; Hiscock v. Varick Bank, supra; Marshall v. State of New York, 254 U. S. 380, 41 S. Ct. 143, 65 L. Ed. 315."

See:

General Motors Acceptance Corporation v. *Coller,* (6 Cir.) 106 F. (2d) 584, cert. den. 60 Sup. Ct. 723, 309 U. S. 682, 84 L. Ed. 1026.

The bankruptcy rules of equal distribution generally applied in insolvency proceedings is inapplicable where the parties actually intended to subordinate their claims and any attempt to compel the certificate holders or the trustee respondent to surrender any superior right they

hold without adequate compensation is inequitable and unfair (*St. Louis Union Trust Co.* v. *Champion Shoe Machinery Co.*, [8 Cir.] 109 F. [2d] 313).

The same result found by the court below will be reached by determining that special equities exist in favor of the certificate holders or by finding that an actual agreement exists to subordinate the defaulted guarantor's claim to those certificates sold to the public (*Bird & Sons Sales Corp.* v. *Tobin*, [8 Cir.] 78 F. [2d] 371, 100 A. L. R. 654).

POINT III

The Federal Court should follow and apply the decisions of the Court of Appeals of the State of New York.

The United States Circuit Court of Appeals for the Second Circuit and the United States District Court for the Eastern District of New York properly applied the principles enunciated in *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188, 114 A. L. R. 1487.

The Circuit Court of Appeals for the Second Circuit in *In re Prudence Company, Inc.*, 82 F. (2d) 755, cert. den. 298 U. S. 685, 56 S. Ct. 787, followed and applied the decisions of the Court of Appeals of the State of New York construing contracts existing between The Prudence Company, Inc., and Prudence-Bonds Corporation with the certificate holders as contracts made and to be performed in the State of New York and therefor governed by the laws of the State of New York or the decisions of the Court of Appeals. See page 757:

> "The contract was made and was to be performed in New York concerning trust property there. We adopt the construction of the highest court in that state as to its meaning and effect. Hiscock v. Varick Bank, 206 U. S. 28, 27 S. Ct. 681, 51 L. Ed. 945; Prudential Ins. Co. of America v. Liberdar Holding Corporation (C. C. A.) 72 F. (2d) 395."

POINT IV

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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of Counsel.